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NO. 917

IN THE

Supreme Court of the United States

October Term, 1968

W. H. COCKE, ET AL., *Petitioners*

v.

UNITED STATES OF AMERICA, *Respondent*

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Fifth Circuit

REPLY BRIEF OF PETITIONERS

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We desire to file this reply brief to the brief in opposition by the respondent.

First, let us show briefly how wrong the decision below is. Petitioners owned an undivided interest in certain oil properties. Humble wanted to do the drilling and operating and was willing to pay petitioners' share of the development and operating expenses and look only to petitioners' share of the oil for reimbursement for petitioners' share of the expenses. Those representing the Government in

this case take the position exactly opposite to that of the Government in the Seventh Circuit in 1956 in *Commissioner of Internal Revenue v. Slagter,* 238 F.2d 901. Those presently representing the Government say that the oil and gas business is entirely different from all other businesses and cases involving it must be decided on the "modern concept of economic interest." Now, the fact that the oil and gas business is no different from any other business was pointed out by the Government itself in the *Slagter* case and the Seventh Circuit so held. A partnership, badly in debt, needed half a million dollars to continue its operation of producing oil. It borrowed this amount from another company and assigned to it sixty per cent of all the oil and gas saved by it. The Court sustained the Government's position that the amount paid to the lending company was nevertheless taxable income of the partnership, saying at 238 F.2d 904-905:

> "The production of oil and gas is an income-producing operation similar to a manufacturing business carried on on land. Anderson v. Helvering, 310 U.S. 404, at page 408, 60 S.Ct. 952, at page 954, 84 L.Ed. 1277, and cases there cited. The assignment here was similar in effect to a mortgage upon real estate or a manufacturing plant, conveying absolute title to the property to the mortgagee, but providing that upon payment of the amount stipulated it shall come to an end. If the mortgage be upon a factory, *even though there is no personal liability upon the part of the assignor,* if the assignor pledges the net proceeds of the operation of that factory, when those profits are realized and paid to the mortgagee, they are paid for the economic benefit of the mortgagor. They are his income, taxable as such.
>
> *"It is suggested by the taxpayers that there was no promise upon the part of the partnership to repay*

> *the funds.* We think that circumstance does not weaken the effect of the assignment as a promise to pay the income of the assignors to the assignee. It is not alone the personal promise of the assignor to repay that determines the relationship of the assignor to the income realized.
>
> "We conclude that the income in question was taxable as ordinary income of the taxpayers as it accumulated and was paid from time to time to Ashland, and that the tax liabilities should be computed for the years in question upon the amounts of income thus realized and paid to Ashland in the respective periods. . . ." (Emphasis added)

We ask: What is the difference between that case and our contentions in this case? The answer is "absolutely none."

Suppose that in this case petitioners had arranged with an insurance company to pay their bills when presented by Humble and had ordered all pipeline companies purchasing their oil to pay the proceeds to the insurance company. Could it conceivably be held that the income was that of the insurance company? Of course, it could not and for the same reason the court below was wrong in holding against petitioners.

We all know that in the present tremendous building activity insurance companies are loaning money to construct buildings and taking only a lien upon the building and underlying ground and an assignment of the rents to secure their loans without any personal liability on the part of the owner of the building. Yet none of these insurance companies are held to be taxable on the rents that are applied by them on the loans as their taxable income. There is no difference between that situation and that of the petitioners in this case.

We again say that the decision below is in direct conflict with the Sixth and Tenth Circuits in *T. K. Harris Co. v. Commissioner,* 112 F.2d 76 and *Reynolds v. McMurray,* 60 F.2d 843, and with the Tax Court in *Byron H. Farwell v. Commissioner,* 35 T.C. 454 (1960), and with this Court in *Crane v. Commissioner of Internal Revenue,* 331 U.S. 1, upon which latter case that of *Commissioner v. J. S. Abercrombie Co.,* 162 F.2d 338 was based. How can the present representatives say the *Harris* and *McMurray* cases are out of date because of the modern concept of "economic interest" when the courts in 1956 in the *Slagter* case (cited with approval in 1962 by the Fifth Circuit in *Sowell v. Commissioner,* 302 F.2d 177) and in 1960 in the *Farwell* case found no such modern development?

Another fallacy of the position of the Government and of the Court below is their attempt to justify the decision on the basis of the "risks" involved. For example, the Court below concluded its opinion as follows (Petition p. 76):

> "The argumentative justification for liberality in taxation of oil and gas is that such liberality encourages and emboldens the fiscally timid to exploit the hidden resource. *It rewards the risktaker. Here Humble risked the exploration and development costs.* If tax emoluments are to be granted, it would be cynicism in the name of economic bravery to give the tax break to the economic observer." (Emphasis added)

Likewise, the Government on page 7 of its brief in this case states:

> "In carried interest transactions it is the carrying party who, until payout is completed, has the de-

> pletable economic interest in the specified portion of production to which he is entitled to look for recoupment of the costs he has advanced for the carried party's account. *The carrying party has invested the costs advanced, and is dependent solely upon income derived from extraction—if, as and when there is production—for a return of his investment.* Hence the portion of production income to which he is entitled, in recoupment of expenses advanced, is his taxable income and includible in his depletion base." (Emphasis added)

Neither the Sixteenth Amendment nor the Internal Revenue Code speaks of "risk." The first simply empowers Congress to "collect taxes on income." Section 1 of the Code simply says "there is hereby imposed on the taxable income of every individual. . . ." If the question of risk is important, what about the financial risks taken by petitioners when they went out and bought leases and then arranged for Humble to operate them. They risked those outlays just as much as Humble did by spending money on drilling. "Risk" is no proper basis on which to decide this case.

We have been representing oil people since 1920 and know of no case that would have had as wide effect in the whole oil industry as this one if the decision below is allowed to stand. The Government in its brief (page 13, footnote 9) states that there are only 10 cases pending like this one and five of them are those of petitioners for later years. We have never known that the importance of a case depends on the number of active cases currently pending. Rather, we submit its importance is in the fact that throughout the oil industry there are many, many such contracts that so far are not in litigation. The importance of the case was pointed out by Judges Ains-

worth, Gewin, Bell and Coleman in their concurring and dissenting opinion (Petition, p. 81):

> "We are informed that there are ten pending cases in the Internal Revenue Service involving carried interest transactions, five of which affect the Cockes. The popularity of the carried interest agreement in the petroleum industry permits the inference that it is likely there are a large number of such contracts in existence which will now be affected by our decision."

We have pointed out in our Petition that the Government tried for years to write regulations covering this idea of treating the income retained by the so-called "carrying party" as its income and finally had to give it up entirely. This and the importance of this case have been dealt with by the Tax Section of the American Bar in The Tax Lawyer, Bulletin of the Section of Taxation, American Bar Association, Winter 1969, Vol. 22, No. 2, pp. 266-269, 273. We set out in Appendix A hereto that part of its report dealing with carried interest and we invite this Court's attention to that report but give at this point only the conclusion:

> "Conclusion
>
> "In view of the many questions in the field of G.C.M. 22730 presently pending before the courts, and those as to which recent decisions of the courts have created new uncertainties, general agreement on any restatement of the principles of the G.C.M. broadly acceptable at once to taxpayers and the Service seems unlikely. In the area of the G.C.M., it may be that, as in other fields of law, taxpayers will be forced to continue to seek their answers on an individual ad hoc basis through resort to the courts."

As stated above, we know of no other case that will have as wide ramification throughout the entire oil industry as this one and for that reason this Court should pass upon the questions involved.

The trouble with those in the Government who try to get away from the *Abercrombie* case is that they do not know anything about the oil business. They are constantly talking about there being no "personal liability," and about the shifting of the income during the "payout period." For example, we quote the following from the Government's brief on page 5:

> "The carried party is not personally liable for costs. . . ."
>
> "The question is whether the portion of production income which is shifted *pending payout* from the carried to the carrying party is income for tax purposes to the former or to the latter."

We have shown that the matter of personal liability is wholly immaterial. Likewise, in a case like the present, there is never any complete "payout." The operator Humble is obligated to pay not only the drilling expenses but all current operations from day to day and has the right to recover petitioners' portions from their part of the oil. Consequently, there never is a complete payout and when the Government people try to solve these questions on the theory of a payout period, they come to realize that they just cannot handle the question by regulations.

We have always felt that the expression "carried interest" is an unfortunate and completely misleading one. It infers that Humble was carrying petitioners free and

clear. However, Humble was at no risk and, when it is drilling a well today, it knows that it will recover the petitioners' costs through their present and future production.

We submit that the case is of such importance that our petition for writ of certiorari should be granted.

There is another question which we will not discuss in detail as it has been fully covered by our Petition. It is the error of the Court below in not making its decision overruling the *Abercrombie* case entirely prospective as to these petitioners. As pointed out in our Petition, four Judges of the Court below dissented and stated that it should be made purely prospective. The Government in their brief in this case state that petitioners should never have relied on the *Abercrombie* case of 1945 and subsequent cases following it because the Commissioner of Internal Revenue from time to time stated that he would not follow *Abercrombie* (Brief, 12-13). This is simply a statement that no one may rely on any decision at any time if the Commissioner says he does not like it. That is no basis upon which the refusal of the Court below to make its decision prospective as to petitioners can be sustained.

The Fifth Circuit decided the *Abercrombie* case in 1947 and followed the rule laid down there until in 1968 in this case an entirely new group of judges in that Circuit reversed the *Abercrombie* case. When these petitioners made their contracts involved in this case in 1955 and 1956 they relied upon this long-standing rule in the Fifth Circuit. They now have involved all of their operations under these contracts since 1956. The properties are still producing and petitioners will be involved in this

same question for years to come. We submit it is wholly unfair on the part of those representing the Government to say that, if this Court should sustain the overruling of *Abercrombie*, such action should not be made prospective as to these petitioners.

CONCLUSION

We respectfully submit that this case is of such importance that our petition for writ of certiorari should be granted and the case be set down at least upon the summary docket as it could be readily presented in the usual thirty minutes allowed in such cases.

Respectfully submitted,

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APPENDIX A

BULLETIN OF THE SECTION OF TAXATION AMERICAN BAR ASSOCIATION

REPORT ON PROPOSED REVISION OF GENERAL COUNSEL'S MEMORANDUM 22730

By Subcommittee of Committee on Natural Resources

(a) *Carried Interest*

Although the term "carried interest" in its broadest sense includes owners of all types of interests who are entitled to receive a share of the proceeds of production but do not bear a proportionate part of the cost of drilling, equipping or operating, the term as used herein will be limited to arrangements between the parties who are or who, pursuant to agreement, will become co-owners of the operating rights in oil and gas properties. Such an owner has made a contribution to the reservoir of capital investment of the several parties and is entitled to share in the proceeds of the minerals produced. He is "carried" to the extent that under the terms of the governing instruments and the applicable law he is not obligated to bear and pay that portion of the drilling, equipping and operating costs of the well or wells equal to his proportionate share of the gross production.

With the possible exception of the uncertainty of the limits of what constitutes an "economic interest," the "carried interest" area has provoked the most litigation and apparently the end is not in sight. This is one of the principal problem areas in any reconsideration of G.C.M. 22730.

G.C.M. 22730 states that the carried party has a non-depletable contractual right during the carrying period

and that the carrying party's advances are charged to a capital account.

Current view varies, depending generally on whether the transaction is a *Manahan, Herndon, Abercrombie* or *Burton-Sutton* type of arrangement, described below. In *Manahan Oil Co.*, 8 T.C. 1159 (1947), the carried party assigned its interest in the property to the carrying party until the payout was reached, and the Tax Court held that the carrying party was entitled to all the income and deductions during the payout period. If the carried party is entitled to share in the income and expenses thereafter, the carrying party must assign whatever basis he has remaining in the original investment in depreciable assets (and which is applicable to the interests of the previously carried party) to his depletable base. If the carried party receives an interest in the equipment when he comes back in, he will have to assign whatever basis he had in the original interest between the depletable and depreciable assets in accordance with their respective values. But, as to such conversion of depreciable costs into depletable costs, or vice versa, see *Choate v. Commissioner*, 324 U.S. 1 (1945).

In *Herndon Drilling Co.*, 6 T.C. 628 (1946), the carried party assigned a 75% interest in the working interest to the carrying party and in addition, assigned a production payment payable out of the 25% working interest retained. The production payment was of an amount equal to the expenditures to be made by the carrying party in drilling and developing the property, plus the profit factor. The carrying party then developed the lease 75% for his own benefit and 25% as consideration for the assigned production payment. The court held that the carrying party would be entitled to all the income

during the payout period but that he must account for such income as attributable to two separate property interests, 75% to the working interest and 25% to the production payment. The carrying party was allowed to deduct 75% of the intangible drilling and development costs and other expenses but was required to capitalize the remaining 25% of such items as well as 25% of cost of the tangible equipment as cost of the production payment acquired from the carried party.

In *Commissioner v. Abercrombie,* 162 F.2d 638 (5th Cir. 1947), the carried party assigned 75% of the working interest to the carrying party. The parties then entered into a contractual arrangement by which the carrying party was to advance the funds to develop the carried party's retained 25% interest. Although the carried party had no personal liability for repayment of these funds, the court held that he had a present interest in the production and improvements, subject, of course, to a lien held by the carrying party on both production and equipment as security for payment of the funds advanced. During the payout period the carried party was required to account for and was taxable on 25% of the income less 25% of the cost and expenses attributable to his interests. The carrying party was required to treat the advance as accounts receivable which if not paid by production or foreclosure of the lien on equipment would constitute a bad debt. The same rationale was followed by the Fifth Circuit in *Prater v. Commissioner,* 273 F.2d 124 (1959) and again by the District Court in *Cocke v. United States,* 263 F. Supp. 762 (D.C. Tex. 1966).

On appeal, the *Cocke* case was first submitted to a regular three judge panel of the Fifth Circuit but before any opinion was filed, reargument of the case before the court *en banc* was ordered. In its opinion (399 F.2d 433

(5th Cir. 1968), following the *en banc* hearing, the court reviewed the history of the litigation involving carried interests and held that the economic interest, as to the carried interest in the property, was in the carrying party sustaining risks in the development of the property recoverable only from production therefrom. The court thus overruled its earlier decision in *Abercrombie*. In so doing, though some arguable factual distinctions were present, it aligned itself with the decision of the Ninth Circuit in *United States v. Thomas*, 329 F.2d 119 (1964).

The decision in the *Cocke* case clarifies the situation where the carrying party may look only to production from the carried interest to recover his costs, but leaves the question unresolved where proceeds of the production might accrue directly to the carried party and where the carrying party might look to the general credit of the carried party but only to the extent of production proceeds actually received by that party. Cf. *Anderson v. Helvering*, 310 U.S. 404 (1940). Substantially the same economic risk is present in each case, because it is the deriving of substantial production from the property, or the failure thereof, which determines whether the carrying party will recover his advances.

In *Burton-Sutton Oil Co. v. Commissioner*, 328 U.S. 25 (1946), the carried party assigned his entire working interest in the lease and reserved a 25% net profits interest. The carrying party as owner of the operating interest was entitled to deduct all intangible drilling and development costs and expenses for the life of the property. Where the carried party will again receive income when the property reflects a net profit, he will at that time be entitled to the depletion allowance on the amount received. The carrying party will calculate his percentage depletion on his share of the gross income from the lease

excluding therefrom the landowner's royalty, any other overriding royalties and the carried party's net profits interest.

There are, of course, many other variations of the carried interest arrangment, all of which make it difficult if not impossible to find any consistent legal theory that can be applied to resolve the many problems between: (1) the assignor and (2) the assignee, with respect to the following questions: (a) who must report the income, (b) how much income should be reported, and, with respect to deductions, (c) who is entitled to the deduction for intangible drilling and development costs, (d) whether he is entitled to deduct all or only a fractional part, (e) if only a fractional part, then how is that fraction to be determined, (f) whether the balance is capitalized, and, if capitalized, is it to be recovered through depletion or depreciation, or part of both, (g) who is entitled to deductions for all operating expenses, (h) whether he is entitled to deduct all operating expenses or only a fractional part, (i) if only a fractional part, what happens to the balance of these expenditures, (j) who is entitled to the deduction for depreciation, (k) whether he is entitled to deduct all depreciation or only a fractional part, (l) if less than all, what happens to the balance of depreciation, (m) does the carried party realize income upon reversion of an interest in the lease and equipment to him, (n) can the carried party then take any depreciation allowance on his interest in this equipment, and (o) what happens to the carrying party's unrecovered basis in the equipment (and perhaps in the lease) at the time of the reversion to the carried party? In addition, a similar line of questions will arise with respect to investment credit.

* * * * *

CONCLUSION

In view of the many questions in the field of G.C.M. 22730 presently pending before the courts, and those as to which recent decisions of the courts have created new uncertainties, general agreement on any restatement of the principles of the G.C.M. broadly acceptable at once to taxpayers and the Service seems unlikely. In the area of the G.C.M., it may be that, as in other fields of law, taxpayers will be forced to continue to seek their answers on an individual ad hoc basis through resort to the courts.